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SUBJECT: BABIL PRT: BABIL'S BANKS STRUGGLE TO FOSTER PRIVATE SECTOR
DEVELOPMENT

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11. (SBU) SUMMARY: Babil's political, academic, and business leaders have repeatedly identified access to capital and the functionality of the banking sector as the top impediment to greater private sector development in the province. While the number of private sector banks in Babil has increased and the ease of financial transactions has improved over the last few years, most banks struggle to fill the primary role of financial intermediaries: to attract deposits and lend funds to "credit-worthy" enterprises. Many Babil residents polled by the PRT avoid putting their savings into local banks because of poor customer service, fears of publicizing their wealth, the proliferation of counterfeit money, and religious considerations. Despite the widespread utilization of guarantees by the USAID-funded Iraqi Company for Bank Guarantees, private banks' archaic collateral requirements prohibit greater lending. State-run banks offer less hope. Those that provide loans are rife with corruption, while others solely serve the role of a government cashier. The PRT has launched a new program to develop linkages between banks and business incubators, such as the Small Business Development Centers in north and south Babil. Still, national level constraints such as land titling and the classification of microfinance institutions as non-governmental organizations limit greater lending to Babil's credit-thirsty private sector.
END SUMMARY.

FEEBLE LENDING

12. (SBU) State-run banks in Babil serve less as banks in the traditional sense than Sovietesque organs of the state that pay out government salaries and subsidize niche sectors. Iraq's two largest banks, Rafidain and Rashid, maintain branches throughout the province. They offer few loans other than to state-owned enterprises, but rather serve as cashiers for the state by paying government salaries and receiving payments to government entities, such as permits and fines. Rafidain and Rashid, because they are involved only minimally lending, do not have widespread reputations for corruption, although Babil customers tell us that some baksheesh can facilitate what otherwise would be protracted routine transactions. The other state-run banks operating in the province are widely believed to be rife with corruption. These include the Mortgage Bank, Industry Bank, and the Agriculture Bank. A group of Najaf farmers recently described to the PRT the manifold layers of "hidden official fees" within the Agriculture Bank. Customers must pay off numerous officials at all stages of the lending process; these fees can add up to as much as 20 percent of the value of the nominally zero-percent loan. The Mortgage Bank has a widespread reputation of being the most corrupt bank in the province,

providing loans only to those with personal connections to its employees.

13. (SBU) The number of private banks operating in the province has jumped from two in 2003 to nine today, not including microcredit organizations such as Izdaharona and CHF International. Consistent with a 2007 USAID/Izdahar analysis of the national banking sector, Babil's private banks appear to maintain very low loan/deposit ratios. The director of the Bank of Baghdad, which comes closest to resembling a modern bank, told us that loans account for about 80 percent of business. This appears, however, to be the outlier. The office manager of Economy Bank said that 95 percent of its business is facilitating government-funded projects, mainly in the construction sector. (Note: This may be explained by the fact that state-run Rafidain Bank is a 60 percent stakeholder in Economy. End Note.) The head of the Beirut-based Iraq Middle East Investment Bank touted the 4.5 billion Iraqi dinar (3.8 million USD) of lending it had provided since opening its Hillah branch in the last four months, but conceded that lending only accounted for about 20 percent of its business. Like other private sector banks, the director said its core operations were foreign exchange transactions; wire transfers; and current (checking) and savings accounts.

14. (SBU) Microcredit organizations such as CHF International and Izdaharona provide some microcredit lending to small enterprises. From our outreach to the business community and Babil, it appears CHF's loan programs are better known than those of Izdaharona and that "word of mouth" marketing is responsible for public awareness of the institutions' lending programs. As of early 2009, CHF's portfolio in Babil was valued

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at USD 3.5 million, made up of around 2000 active clients. Terms range from one to two years with an effective interest rate of 25 percent. Loans are generally guaranteed by one or two government employees and sometimes by collateral. Repayment rates are 99 percent. The local head of CHF's implementing partner told us CHF has used both the public Rafidain Bank and the private Al-Warka to process its loans, but has been generally unsatisfied with the Rafidain's untimely processing of statements.

ARCHAIC COLLATERAL REQUIREMENTS

15. (SBU) Despite the widespread utilization of guarantees by the USAID-funded Iraqi Company for Bank Guarantees (ICBG), which numerous banks throughout the province touted, archaic collateral requirements inhibit more robust lending. Babil's business community complains that few potential borrowers have the necessary real estate collateral to secure a loan. The government still owns 80 percent of the province's agricultural land, and much of the province's commercial real estate stock consists of long-term building leases to businesses on land owned by the government; such leases cannot be used as collateral for loans. Although ICBG guarantees 75 percent of the value of all its loans, Bank of Baghdad also secures "most" of its loans with gold. To demonstrate, Bank of Baghdad's manager showed us a burlap sack of gold jewelry recently given to the bank to secure a loan (for approximately 75 percent of the value of the gold, measured by weight). Al-Warka Bank secures all of its loans by taking possession of deeded real estate. Iraq Middle East Investment Bank uses ICBG to secure small loans, for which there must be two federal government employee cosigners; for large loans, the bank requires real

estate as collateral. The cosignatory requirement is intended as a means of recouping funds -- by docking the salary of the government employee -- should the loan not be repaid. In practice, however, numerous private bankers told us, this is almost never done.

FINANCIAL SERVICES EVOLVE...

16. (SBU) Private sector banks offer an array of financial services and are showing increased technological sophistication. Wire transfers, and letters of credit are widely available and the ease of conducting these transactions has greatly improved over the last few years. Private banks in Hillah offer foreign exchange transactions, pending the availability of funds. During a recent visit to the Economy Bank, however, the bank manager told us that the bank had not had any US dollars in two months, which he claimed was due to security along the route from Hillah to Baghdad. Some private banks, including Bank of Baghdad and al-Warka Bank, have ATMs, although there are no secure networks that might allow an ATM card at one bank to be used at a rival institution. Bank of Baghdad recently launched a prepaid Visa card service that acts like a gift card. While there are no outlets in Hillah that accept Visa, Bank of Baghdad told us they launched the product to tap into Iraqi demand for e-commerce. Despite this range of technological innovations, however, many of these products are underutilized because of the requirement that customers be deposit holders. A customer hoping to send a wire transfer, therefore, must already hold a current account at the bank.

... BUT CUSTOMER CONFIDENCE LAGS

17. (SBU) Despite technological advances, customer confidence in the banking sector has lagged. Nowhere do Babil's financial institutions showcase their statist legacy more than in the level of their customer service. While Bank of Baghdad has automated customer tracking systems, other institutions rely on paper-based transactions. Automated interbank systems are beginning to come on line, but in the meantime checks can take weeks to clear. Recently, Bank of Baghdad, after opening a few hours late because of a power shortage, finally allowed the

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cluster of customers waiting outside the door in the mid-morning heat to enter the bank only after they had queued up alphabetically by last name. Banks also face a great deal of micromanagement from their headquarters, which causes delays in loan processing. Economy Bank only rarely has the discretion to award loans (requiring Baghdad's approval first), whereas al-Warka Bank said all decisions must come from its chairman in Amman. When banking proves to be such a hassle, it is little surprise many choose to keep their money in their mattress or in gold. Given the routine delays in accessing funds when the security situation is relatively good, many Babil residents have also voiced fear that their deposits might be inaccessible should violence spike, whether due to bank looting or a bank run.

18. (SBU) Additionally, fears of publicizing one's wealth, the proliferation of counterfeit cash, and religious concerns about usury undercut demand for use of banking services. Babil businessmen have told us that they fear depositing large sums of

money in any bank lest their wealth be known, even by bank employees. By some estimates, as much as 20 percent of the cash in circulation in Babil is counterfeit. Customers fear bring their money to the bank, where counterfeit will be immediately seized and destroyed with no compensation to the customer; there is instead a better chance of being able to pass along fake currency, even if unwittingly acquired, in the marketplace. Finally, with only one Islamic finance institution operating in the province (the newly established Elaf Bank), the more religious elements in Babil tend to eschew financial institutions altogether.

PRT BABIL'S SME-BANK LINKAGE PROGRAM

¶9. (SBU) Babil PRT's first business environment conference in February (reftel) revealed the mutual frustration felt by capital-laden banks and the Babil business community. During the conference, four independent working groups representing a cross section of the Babil political, academic, and business elite identified access to capital as the top constraint to greater private sector development in the province. In response, Babil PRT's economic development strategy reflects the imperative that we move out of the business of doling out grants and focus our efforts on building sustainable financial institutions. We recently launched an initiative to facilitate greater linkages between financial institutions and potential borrowers through Babil's Small Business Development Centers. The goal of the linkage program is to better inform the business community, in particular SMEs, on each private bank's criteria for approving a business loan. Since the terms and conditions, interest rates, and collateral requirements differ from one bank to another, an SME ought to be matched with the most appropriate loan portfolio as communicated through its local business association. In order for this model to be successful, the business associations operating in Hillah need improved relations with the banks so they remain up-to-date on the loan programs offered. This model builds bank-SME trust and intercommunication, increases the rate of SME loan approvals by training prospective SME borrowers on "bankability," and builds business sustainability with less reliance on business grants from foreign donors.

COMMENT: NATIONAL LEVEL CONSTRAINTS ENDURE

¶10. (SBU) Policy constraints at the national level undercut the best of efforts to bring together local financial institutions and potential borrowers at the provincial level. The fact that real estate collateral is almost never seized and government salaries of loan cosigners never docked for nonperforming loans underscores the extreme institutional risk aversion to lending to anyone but those already deemed "rich"; doing so denies credit to scores of other potentially responsible borrowers. Development of a universally recognized credit rating and information system would obviate the need for archaic gold-based collateral requirements, civil servant cosignatories, and stringent real estate capital requirements. It would also encourage lending based on technical loan criteria rather than personal connections. Policy reforms that address Iraq's

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antiquated zoning and land titling system would expand the pool of potential borrowers. The lack of deposit insurance makes banks further risk averse about lending out customers' deposits. Finally, the current classification of microfinance

organizations such as CHF and Izdaharona as non-governmental organizations, subjects them to overly burdensome oversight by the Prime Minister's office rather than an Iraqi entity well versed in financial regulation.

HEATH